No. 7128

In the United States Circuit Court of Appeals for the Ninth Circuit

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ERLE P. HALLIBURTON, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

AND

VIDA C. HALLIBURTON, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITIONS FOR REVIEW OF DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The only previous opinion is that of the United States Board of Tax Appeals (R. 51–57), which is reported in 25 B.T.A. 1045.

JURISDICTION

This case involves two proceedings which were consolidated for hearing before the Board. Two appeals were filed, one involving income taxes for the calendar year 1924 in the case of Erle P. Halliburton in the amount of $23,946.10 and the other involving income taxes in the case of Vida C. Halliburton for the same year in the amount of $21,649.89. The appeals are taken from the orders of redetermination entered March 31, 1932 (R. 58–59). Petitions for review were filed September 23, 1932 (R. 72–83, 84–95), pursuant to the provisions of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109, 110, Sections 1001, 1002, and 1003, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTIONS PRESENTED

1. Petitioners were equal owners of a partnership. They, with seven certain oil companies, agreed to create a corporation to which the partnership was to transfer assets in exchange for 1,780 shares of capital stock and the oil companies were to purchase 1,300 shares of the capital stock for cash. The question is whether the subsequent transfer of the partnership assets is a transaction in which no gain is to be recognized or a sale from which a profit was derived. The answer to this question will depend on whether the petitioners controlled at least 80% of the capital stock of the successor corporation immediately after the exchange.

2. Whether any part of the gain realized from the sale is subject to the capital gain provisions of Section 208.

STATUTES INVOLVED

They will be found in the appendix, *infra*, pp. 19–21.

STATEMENT

The facts found by the Board of Tax Appeals are as follows (R. 46–51):

The petitioners are individuals now residing at Los Angeles, California. In the taxable year they were equal owners of a partnership known as E. P. Halliburton Oil Well Cementing Company with its principal place of business at Duncan, Oklahoma.

The E. P. Halliburton Oil Well Cementing Company, hereinafter called the partnership, was established in 1920 and until July 1, 1924, profitably operated the business of cement oil wells by use of a process patented by Erle P. Halliburton on March 1, 1921. It used several patents, one patent license, all the equipment necessary to its business, certain real estate, supplies, and accounts receivable.

On June 19, 1924, the petitioners, as parties of the first part, entered into a written contract hereinafter called the promoter's agreement with seven certain oil companies as parties of the second part, which provided for the organization of a corporation under the laws of Delaware to be known as the Halliburton Oil Well Cementing Company, hereinafter called the corporation, with authorized cap-

ital stock of the par value of $350,000 divided into shares of $100 each. Under the terms of the contract the parties of the first and second part agreed to subscribe and pay for 1,780 and 1,300 shares of stock of the corporation, respectively. The remainder of the authorized shares was to remain in the treasury of the corporation for sale to the public.

The promoter's agreement provided that the Board of Directors should be made up of seven persons, three to be selected by the stock held by parties of the first part, three by the stock held by parties of the second part and one to be chosen by Erle P. Halliburton and the second parties or by the president of a trustee which was to hold 480 shares of the corporation's stock to be paid for the partnership assets on July 12, 1924. It also provided that Erle P. Halliburton should be president and general manager of the corporation at a salary of $15,000 per annum; that H. C. Gloeckler, a representative of the parties of the second part, should be vice president on a salary of $4,200 per annum; and that a secretary-treasurer to be selected by the parties of the second part should receive a salary of $4,200 per annum.

On July 12, 1924, a meeting of the Board of Directors attended by six members thereof was held. At this meeting the certificate of incorporation and the bylaws adopted at the incorporator's meeting held at Wilmington, Delaware, on July 1, 1924, were duly ratified and adopted and the persons so designated in the promoter's agreement

were elected to the respective offices of president, vice president and secretary-treasurer at the salaries specified in such agreement.

The parties of the first part, the petitioners, paid for their stock in the corporation in conformity with the terms of the promoter's agreement by delivering to it the goodwill of the partnership, patents 1,369,781 and 1,486,883, a license to use a patent 1,101,484 owned by a competing concern, and a mixed body of partnership assets. The cost and value of the assets appear on page 49 of the Record.

It is stipulated that included in the above list was property of the depreciated cost of $16,216.51 which had been owned by the partnership for more than two years.

The parties to the proceeding agree that on July 1, 1924, the corporation received all the property listed above and from that date retained continuous possession thereof and operated the oil well cementing business theretofore carried on by the partnership. On and after such date all operating contracts were made in the name of the corporation which then opened a set of books that reflect its income and operations thereafter. At all times after July 12, representatives of the parties of the second part served on the Board of Directors and as officers of the corporation and participated in all its corporate acts and proceedings.

The real estate included in the list of partnership assets was transferred to the corporation by deed dated July 1, 1924, but the signatures of Erle P.

Halliburton and Vida C. Halliburton affixed thereto were not attested until July 16 and July 23, respectively. The patents and patent rights included in the assets transferred were assigned to the corporation by instruments dated July 1, 1924, but the signatures thereto were not attested until July 23, of such year.

On July 23, 1924, the parties of the second part paid in their subscription on the stock of the corporation in cash in the amount of $130,000.

Immediately after the effective date of the organization of this corporation, Erle P. Halliburton and Vida C. Halliburton owned capital stock of the corporation represented by 1,780 shares of stock issued, or to be issued, for which they had paid in the assets of the partnership as above set out. The parties agree that the stock so acquired had a fair market value equal to the par value of $178,000 at date of its issue.

Each of the petitioners herein made an income tax return for 1924. Neither included in such return any profit resulting from the transfer of the assets of the partnership to the corporation. Upon audit the respondent determined that the effective date at which the corporation began business was July 23, 1924, and that profit was realized from the sale of the partnership assets to the corporation and asserted the deficiencies here in controversy.

The Board approved the Commissioner's determinations and the petitioners' appeal.

SUMMARY OF ARGUMENT

Section 203 (a) provides for the recognition of the gain determined upon the sale or exchange of property. To this general rule there are several exceptions. Petitioners seek the benefit of the exception found in Section 203 (b) (4) which provides in substance that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation. Pursuant to an agreement entered into between the petitioners and seven certain oil companies, a corporation was organized to which petitioners transferred the assets of their partnership business in exchange for 1,780 shares of stock and the seven oil companies purchased 1,300 shares for cash.

Petitioners argue that immediately after the transfer of the partnership assets to the corporation the partners owned all the outstanding stock since the stock which the oil companies had agreed to purchase was not sold to them until twenty-three days after the partnership assets had been transferred and therefore the transfer of the partnership property was claimed to be an exchange within Section 203 (b) (4) in which no gain or loss is recognized. However, the contract entered into between the petitioners and the oil companies contemplated the organization of the corporation and the issuance of stock to the partners for their assets

and the issuance of stock to the oil company for cash. The whole transaction was the means adopted to carry out the contract. In subtsance there was but one single transaction and when it was fully consummated the partners did not control the corporation, that is, they did not own at least 80% of the outstanding capital stock.

With respect to the second issue the Board was unable to apply the capital net gain provisions of the statute since the petitioners failed to establish the amount of the gain attributable to the sale of patent No. 1369891. This patent, together with goodwill and two licenses to use other patents, were sold with the partnership's tangible assets. While the value of the latter is ascertainable no proof has been presented as to how the balance of the sale price may be distributed among the intangible assets sold.

ARGUMENT

I

The transfer of the partnership assets to the corporation in exchange for stock is not a nontaxable exchange

Petitioners contend that the exchange of the partnership assets for stock of the corporation was a nontaxable transaction on the ground that immediately after the exchange they were the owners of at least 80% of the outstanding capital stock and so remained until July 23, 1924, when the seven oil companies paid $130,000 in cash for the stock for which they had subscribed. It is respondent's con-

tention that the transactions disclosed a taxable profit for the reason that petitioners were not the owners of at least 80% of the outstanding capital stock immediately after the exchange. Respondent further contends that the property was not transferred solely in exchange for stock or securities in the successor corporation.

Section 203 (b) (4) was designed to govern situations where all that takes place is a mere change of form in the taxpayer's holdings.[1] Clearly the

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[1] Section 203 (b) (4) of the Revenue Act of 1924 corresponds to Section 202 (c) (3) of the Revenue Act of 1921. The object of the statute was described by the Senate Finance Committee preparatory to the enactment of the Revenue Act of 1921 in Senate Report No. 275, 67th Cong., 1st Sess., 1921, pp. 11–12, as follows:

"Section 202 (subdivision c) provides new rules for those exchanges or 'trades' in which, although a technical 'gain' may be realized under the present law, the taxpayer actually realizes no cash profit.

"Under existing law 'when property is exchanged for other property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value, if any * * *.' Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments. The existing law makes a presumption in favor of taxation. The proposed act modifies that presumption by providing that in the case of an exchange of property for property no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value, and specifies in addition certain classes of exchanges on which no gain or loss is recognized even if the property received in exchange has a readily realizable market value. These classes comprise the cases * * * where an individual or indi-

transaction consummated pursuant to the promotion agreement of June 19, 1924, was not of this character. Section 203 (b) (4) is rendered operative by the concurrence of two facts: a transfer of property by one or more individuals to a corporation; control (ownership of at least 80% of the outstanding capital stock) of the corporation by the transferor or transferors immediately thereafter. The second requirement is here lacking.

Petitioners needed additional capital (R. 105) and to obtain it they entered into the promotion contract of June 19, 1924, Ex. 1 (R. 116–128), under which it was agreed to create a corporation with a capital stock of 3,500 shares, par value $100 each. Petitioners agreed to subscribe and pay for 1,780 shares. These shares were to be paid for by the transfer by the partnership of certain assets (R. 119). The seven oil companies agreed to subscribe and pay in cash for 1,300 shares upon the organization of the corporation (R. 117–119). On July 1, 1924, the corporation was set up and on that date the partnership delivered the assets to the

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viduals transfer property to a corporation and after such transfer are in control of such corporation.

"The preceding amendments, if adopted, will, by removing a source of grave uncertainty and by eliminating many technical constructions which are economically unsound, not only permit business to go forward with the readjustments required by existing conditions but also will considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."

corporation and the latter began operations (R. 98, 99). Mr. Halliburton did not receive his stock certificates until some time in August (R. 107). The oil companies paid cash for their 1,300 shares on July 23, 1924 (R. 105).

The real estate included in the list of partnership assets was transferred by deed dated July 1, 1924, but the signatures of the partners were not attested until July 16 and July 23, respectively. The patent and licenses included in the assets transferred were assigned to the corporation by instruments dated July 1, 1924, but the signatures thereto were not attested until July 23 of that year. Upon these facts the Board, correctly, we submit, concluded that the organization of the corporation was not completed until all the terms of the promoter's agreement of June 19 were accomplished and that immediately after that date the petitioners were not in control of at least 80% of the outstanding capital stock.

The petitioners and the oil companies entered into a valid contract for the formation of a corporation. The instrument covered in detail the obligations of the parties, the capital structure of the corporation to be formed even to naming the principal officers and the amount of their salaries. A period of twenty-three days was consumed by the parties in carrying out the terms of the contract. The Board of Directors met and elected officers of the corporation on July 12 (R. 144). The legal

title to the patent rights and to the real estate was not transferred until July 23 nor were the stock subscriptions of the oil companies paid until that date.

It is clear that the entire proceeding was the means adopted to carry out the contract between the partnership and the seven oil companies and that it must be viewed as a whole rather than each component part thereof separately. An attempt to break this transaction into two elements disregards the plain intent of the parties. In transactions like the present one, substance and not form determines the applicability of the taxing act. *Labrot* v. *Burnet,* 57 F. (2d) 413 (App.D.C.). What was done amounted to a single transaction for income-tax purposes and when it was fully consummated the partnership controlled approximately 50% of the stock of the successor corporation. The transaction therefore was not within the exception and must be considered a sale.

In *West Texas Refining & Development Co.* v. *Commissioner,* 68 F. (2d) 77 (C.C.A. 10th), an analogous situation was presented. The court said (p. 79):

> It is argued that immediately after the transfer of the properties to the Col-Tex Company by the West Texas Company the latter owned all the outstanding stock of the Col-Tex Company, since the stock issued to the Standard Company was not delivered

until sixteen days later, and therefore the transfer to the Col-Tex Company was a reorganization within the definition thereof in section 203 (h) (1). The assertion, while technically correct, overlooks other facts which disclose the real situation.

The West Texas Company and its stockholders entered into a contract with the Standard Company in June 1925, for the sale of one-half of the stock of a corporation owning the physical assets of the West Texas Company. This contract contemplated the organization of the Col-Tex Company and the sale and issuance of its stock to the Standard Company and the West Texas Company in equal proportions. The contract further contemplated a sale by the West Texas Company of its physical assets for a substantial sum in cash. The Col-Tex Company upon coming into existence agreed to purchase those assets for 2,000 shares of its capital stock and a certain amount in cash. On the same day it also agreed to sell one half of its capital stock to the Standard Company for the same amount of cash. The whole transaction was the means adopted to carry out the contract between the West Texas Company and the Standard Company. In substance it was but one single transaction.

The court concluded that the transaction was not within the exceptions defined in Section 203 of the Act.

An additional reason remains why the transfer may not be treated as a nontaxable transfer. The statute provides:

> No gain or loss shall be recognized if property is transferred to a corporation by one or more persons *solely in exchange for stock or securities in such corporation,* and immediately after the exchange such person or persons are in control of the corporation; * * * (Italics supplied.)

The facts clearly show that the partnership acquired not only stock in the successor corporation in exchange for the assets but also certain valuable rights under the promotion contract. Under the contract the oil companies subscribed for 1,300 shares of the projected company, agreed to pay for them in cash and guaranteed payment for the stock allotted to each company. Petitioners performed their part of the agreement by transferring the assets of the partnership to the corporation. Immediately thereafter petitioners acquired the right to compel the oil companies to perform in accordance with their agreement. Furthermore, it is reasonable to assume under the circumstances that the oil companies held themselves out to be subscribers when the certificate of incorporation was filed. A subscription to the capital stock of a corporation to be formed is in the nature of a continuing offer to the projected corporation and becomes a valid and binding contract upon the formation of the corporation. *Coleman Hotel Co.* v. *Crawford,* 3

S.W. (2d) 1109, and annotations in 61 A.L.R. 1463, 1522.

The corporation and the petitioners as its stockholders were in a position to require payment on the stock subscriptions. Hence, immediately after the transfer, petitioners acquired valuable rights in addition to the stock of the corporation. The property was not transferred solely in exchange for stock or securities. This situation, it is submitted, does not fall within the statute. If the partnership had turned over its property to the corporation solely in exchange for stock and immediately thereafter the partners owned at least 80% of the stock outstanding, the exception in Section 203 (b) (4) would clearly apply. The partnership business would have taken on a mere change in legal form. In the instant case, viewing the proceeding as a single transaction, no such mere change in legal form occurred. The organization of the corporation was executed as planned and immediately thereafter the partnership did not own at least 80% of the outstanding stock since the oil companies owned 1,300 shares of the 3,080 outstanding.

There is no merit in petitioners' contention that they and the seven oil companies transferred properties to the corporation solely in exchange for its stock and immediately after the exchange such group of persons was in control of the corporation

and the amount of the stock received by each was substantially in proportion to his interest in the property prior to the exchange. Section 203 (b) (4) is an exception to the general rule in Section 202 (a) which imposes a tax on the gain realized upon the sale or exchange of property. The seven oil companies transferred no property to the corporation upon which a gain or loss could arise. They purchased stock in the corporation for cash. No gain or loss can be realized upon the purchase of stock. Cash paid for stock is clearly not property within the contemplation of the statute.

II

Petitioners have failed to prove the amount of gain attributable to the sale of Patent No. 1,369,891

Petitioners contend that they are entitled to the benefit of the capital net gain provisions of the statute in determining the amount of the tax due on the profit from the sale to the corporation of patent No. 1,369,891. The Board was unable to determine the amount of the gain allocable to this patent in view of petitioners' failure to establish its selling price.

Under the contract of June 19, 1924, the petitioners transferred various assets to the corporation for $178,000 represented by 1,780 shares of stock having a par value of $100 each. No part of this sale price was allocated to any particular asset. Of this amount $50,493.13 may be allocated to the tangible assets, leaving $127,506.87 attributable to

the intangible assets which included patent No. 1,369,891, licenses to use patents Nos. 1,486,883 and 1,011,484, and the good will of the partnership. No evidence whatever of the value at the date of transfer was adduced for the licenses to use patents Nos. 1,486,883 and 1,011,484, nor of the partnership's good will.

As to patent No. 1,369,891, one of the petitioners testified that its value was at least $100,000 on July 1, 1924. An engineer testified to the same effect. The Board, however, is not bound by opinion evidence, particularly where no facts are presented to support the opinion. *Uncasville Mfg. Co.* v. *Commissioner,* 55 F. (2d) 893 (C.C.A. 2d), certiorari denied, 286 U.S. 545; *Tracy* v. *Commissioner,* 53 F. (2d) 575 (C.C.A. 6th). In *Crowell* v. *Commissioner,* 62 F. (2d) 51 (C.C.A. 6th), it was said (p. 54): "With the probative force of factual inferences reasonably drawn, we have no concern." The Board was of the opinion that the assignment of the value of $100,000 to patent No. 1,369,891 did not take into account the undoubted value of the other intangible assets acquired by the corporation. The good will and the licenses to use the other patents were presumably acquired by the partnership without cost but that they had substantial value can not be denied since they were specifically mentioned in the promotion agreement (R. 120, 121). At least on this point both witnesses could have testified with the same assurance they did respecting the value of patent No. 1,369,891. Peti-

tioners' failure to bring this out seemingly impressed the Board.

Incidentally it may be noted that petitioners assumed that the patent belonged to the partnership. However, the patent was issued to Halliburton and there is no evidence of any assignment thereof to the partnership. He alone would be entitled to the benefit of the capital net gain provisions if they are here applicable. It is submitted that the state of the record does not clearly and convincingly require a conclusion contrary to that rendered by the Board. *Jeffery* v. *Commissioner,* 62 F. (2d) 661 (C.C.A. 6th). The necessity of making an adequate record on appeal in tax cases is emphasized in *Autosales Corporation* v. *Commissioner,* 43 F. (2d) 931 (C.C.A. 2d). The burden of proof must be met definitely. Surmise is not sufficient. *Morris Coal Co.* v. *Commissioner,* 48 F. (2d) 810 (C.C.A. 6th).

CONCLUSION

It is submitted that the decision of the Board is correct and should be affirmed.

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Sewall Key,
John G. Remey,
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March 1934.

APPENDIX

REVENUE ACT OF 1924, C. 234, 43 STAT. 253

SEC. 202. (a) Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in subdivision (a) or (b) of section 204, and the loss shall be the excess of such basis over the amount realized.

(b) In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditure properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previous allowed with respect to such property. (U.S.C., Title 26, Sec. 933.)

SEC. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) (4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

*　　*　　*　　*　　*

(i) As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. (U.S.C., Title 26, Sec. 934.)

Sec. 204. (a) The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property; except that—

* * * * *

(6) If the property was acquired upon an exchange described in subdivision (b), (d), (e), or (f) of section 203, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by paragraphs (1), (2), (3), or (4) of subdivision (b) of section 203 to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it; (U.S.C., Title 26, Sec. 935.)

SEC. 208. (a) For the purposes of this title—

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

*   *   *   *   *

(5) The term "capital net gain" means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

*   *   *   *   *

(8) The term "capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected, and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain. (U.S.C., Title 26, Sec. 939.)

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